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In the Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,

Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether the Bankruptcy Code authorizes a judge to confirm a Chapter 11 plan of reorganization that grants the pre-bankruptcy equity owners of a debtor an exclusive opportunity to retain or purchase an ownership interest in the reorganized debtor, but does not provide for full payment to a senior, objecting class of unsecured creditors.

RULE 24.1(b) AND 29.6 STATEMENT

The parties in the court of appeals were Petitioner Bank of America Illinois, now known, as a result of a merger, as Bank of America National Trust and Savings Association, and Respondent 203 North LaSalle Street Partnership, an Illinois limited partnership.

Petitioner Bank of America National Trust and Savings Association is a wholly owned subsidiary of BankAmerica Corporation, which is a publicly held company. On April 13, 1998, BankAmerica Corporation and NationsBank Corporation announced their intention to merge in the fourth quarter of calendar 1998. Bank of America National Trust and Savings Association has the following non-wholly-owned subsidiaries: 693327 Ontario Limited; BA Card Services, Inc.; BA Holding Company S.A.; BA Insurance Brokerage Inc.; BA Merchant Services, Inc.; BA Securities Investment Advisory Limited; Bank of America (Jersey) Limited; Bank of America Colombia; BJ Services Trust 1997-1; Inchroy Credit Corporation Limited; InverAmerica S.A.; Multi Banco S.A.; and Tiryns FSC, Inc.

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of a divided panel of the court of appeals (Pet. App. 1a-47a) is reported at 126 F.3d 955. The order of the court of appeals denying rehearing and denying rehearing en banc by a 5-5 vote (Pet. App. 48a-49a) is not reported. The opinion of the district court (Pet. App. 50a-101a) is reported at 195 B.R. 692. The opinion of the bankruptcy court (Pet. App. 102a-154a) is reported at 190 B.R. 567.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1997. Pet. App. 1a. A timely petition for rehearing was denied on November 25, 1997. Pet. App. 48a-49a. The petition for a writ of certiorari was filed on February 23, 1998, and was granted on May 4, 1998. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Pertinent portions of the text of 11 U.S.C. § 1129 are set out in the Addendum attached to this brief.

STATEMENT

A. The Absolute Priority Rule

The primary purpose of a Chapter 11 bankruptcy case is to determine whether a plan of reorganization can be judicially approved consistent with the statutory provisions protecting both debtors and creditors; and, if so, to confirm such a plan. To be confirmed, *each* plan, regardless of who proposes it, must satisfy the requirements of 11 U.S.C. § 1129. If the plan satisfies the thirteen requirements of subsection (a) of Section 1129, the plan may be confirmed, without regard to subsection (b) of the statute.

One of those thirteen requirements is that each class of impaired creditors — creditors whose legal rights have been altered and whose claims are not paid in full under the plan — has voted to accept the plan. 11 U.S.C. § 1129(a)(8). For a class to accept a plan, the Code requires an affirmative vote by creditors whose claims constitute more than half of their

class by number and hold at least two-thirds of the total value of the claims in that class. 11 U.S.C. § 1126(c). Allowing a plan to be confirmed on the basis of creditor *consent*, without any further requirement that a court find the plan "fair and equitable," was an important innovation when Congress replaced all prior bankruptcy laws with the comprehensive Bankruptcy Code of 1978. See DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 262 (1993).

The Code also supplies a means — known in bankruptcy parlance as "cramdown" — by which some plans can be confirmed even without the level of creditor consent required by subsection (a). That is the purpose of subsection (b) of Section 1129. If the only one of the thirteen requirements of Section 1129(a) that the plan does not satisfy is the class acceptance requirement of Section 1129(a)(8), the plan still may be confirmed if it "does not discriminate unfairly and is *fair and equitable* with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1) (emphasis added). Although "fair and equitable" is a phrase borrowed from pre-Code absolute priority cases, it is a defined term under the Code. The Code provides that a plan is "fair and equitable" as to a class of dissenting unsecured claims if, among other requirements, creditors with claims or interests junior to those of the dissenting class "will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B)(ii).

This is the absolute priority rule. It requires "that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202 (1988) (internal quotation marks omitted). The rule was originally a judicial development but since 1978 has been part of the Bankruptcy Code. *Ibid.*

Justice Douglas's opinion for the Court in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), contained dicta that have been read to suggest that there was or is a new value exception to the absolute priority rule. *Ahlers*,

485 U.S. at 203. *Case* arose under Section 77B of the Bankruptcy Act of 1898 and presented the question — quite different from the question presented in this case — whether a plan of reorganization that *had* been consented to by 90% or more of each class of creditors and equity holders could be confirmed even though it did not afford a class of creditors absolute priority. 308 U.S. at 111-112. The absolute priority rule was understood at that time (contrary to its present meaning under the Code) to require that a court deny confirmation of a plan unless it was adjudged "fair and equitable," *even if* majorities of all classes of creditors had *consented*. The plan in *Case* failed that standard. To mitigate the potential harshness of a rule that allowed a small minority of dissenters to block confirmation of a plan to which most similarly situated creditors had consented, however, Justice Douglas wrote (308 U.S. at 121-122 (dicta)):

> [T]here are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. * * * Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made. * * * [T]o accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.

Case is universally cited as the precedent that "established" a new value exception to the absolute priority rule (Pet. App. 14a) — even though the Court in *Case* ***rejected*** a plan because it violated the absolute priority rule, and even though the Court's dicta seemed to address the circumstances in which a court might approve a plan over the objection of a ***minority*** of a class of creditors. A new value exception, if it exists on the authority of *Case*, would allow the debtor's pre-petition equity holders the exclusive right to retain an ownership interest in the reorganized debtor, despite not providing for a more senior and unconsenting class in full, if

a bankruptcy judge determines that they have made substantial new contributions in money or money's worth that are reasonably equivalent to the retained interest and necessary to a successful reorganization. Pet. App. 14a.

A new value exception — providing the debtor's pre-bankruptcy owners with an *exclusive* opportunity to retain their ownership interests — is difficult to reconcile with the language of Section 1129(b)(2)(B)(ii) of the Bankruptcy Code, adopted in 1978. On its face, the statute forbids confirmation of reorganization plans under which pre-petition equity holders receive or retain "any" property "on account of" their pre-petition interests in the debtor where a dissenting class of unsecured creditors is not being provided for in full. Proponents of the new value exception maintain, however, that it is not actually an "exception" but a "corollary" to the absolute priority rule, because the post-petition interests acquired under the plan by the debtor's pre-bankruptcy equity holders are received "on account of" the contributed new value instead of "on account of" their status as pre-bankruptcy equity holders. See Pet. App. 17a, 21a.[1] This Court has left open the question whether any new value exception exists. *Ahlers*, 485 U.S. at 203 n.3; *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18, 20 n.1 (1994).

[1] We mention this argument at this point only to explain the "corollary" terminology. There are counterarguments. For one, the "corollary" terminology can be seen as historically inaccurate. See Walter W. Miller, Jr., *Bankruptcy's New Value Exception: No Longer a Necessity*, 77 B.U. L. REV. 975, 1011 (1997) ("The new value exception functioned as an exception to the absolute priority rule, never as part of the absolute priority rule."). Also, under the current Code, opponents counter that the "corollary" argument still fails to bring the exception within the statute because the "property" being retained by the debtor's pre-bankruptcy equity holders in violation of the plain language of the statute is *not* the purchased interests themselves, but the *exclusive* right accorded by the plan to the debtor's pre-bankruptcy equity holders to purchase the new equity interests in the reorganized entity. They are granted that right based on their status as pre-bankruptcy equity holders. See Pet. App. 33a-35a (Kanne, J., dissenting); pp. 19-23, *infra*.

B. Factual Background

The debtor in this case, respondent 203 North LaSalle Street Partnership, is a real estate limited partnership whose principal asset is fifteen floors of an office building in downtown Chicago (the "Property"). Pet. App. 2a. The debtor owes petitioner (the "bank") more than $93 million; the debtor was required to repay the bank's loan, secured by a non-recourse first mortgage on the Property, in January 1995. *Ibid.* When the debtor was unable to repay the loan, the bank began foreclosure proceedings; shortly thereafter, the debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. *Ibid.*

When the bankruptcy court confirmed the debtor's plan of reorganization, the debtor was insolvent and the court valued the bank's secured claim at $54.5 million (the $55.8 million market value of the Property at the time, according to the court, minus the hypothetical cost of disposing of it).[2] The bank was thus left with an unsecured deficiency claim of

[2] In this case, as in most bankruptcy cases, the parties did not and do not agree on the valuation of the collateral. It is an indispensable feature of bankruptcy law that sometimes bankruptcy judges must "resolve" such disputes by "finding" the value of assets. Yet it is impossible to understand the policy implications of the new value debate (or of many other bankruptcy issues) unless one comprehends that the judge's finding does not, in any real-world sense, "establish" for all purposes the one true value of the property. Rather, valuation is an inexact science in the extreme. *Cf. Associates Commercial Corp.* v. *Rash*, 117 S. Ct. 1879, 1886 & n.6 (1997) (discussing various standards of valuation and various factual issues that may arise even under the replacement-value standard). One can no more "establish" the value of a real estate property through a valuation "finding" than one can "establish" the value of a share of stock by making a "finding." Markets on which stock is actively traded exist precisely because opinions about the value of companies differ — often substantially — from individual to individual, and from day to day. Like an investor willing to place his own capital at risk in reliance on a particular view of value, a bankruptcy judge can do his or her utmost to be "right," but there is no guarantee of being "right" on any given day, let alone over time. One cannot understand the real-world stakes in bankruptcy matters without recognition that even the best valuation is uncertain.

$38.5 million. Pet. App. 4a n.4, 115a. (As the Seventh Circuit explained, an undersecured creditor, unless it has affirmatively elected to the contrary, has a secured claim up to the value of the property and has an unsecured claim to the extent the debt exceeds the property's current market value. Pet. App. 3a n.1; see 11 U.S.C. §§ 506(a), 1111(b).)

Under the plan, the bank's $54.5 million secured claim is required to be paid off between seven and ten years after the original 1995 repayment date for the entire $93 million loan. Pet. App. 4a, 55a-58a. With respect to the $38.5 million deficiency claim, the bankruptcy court found that the Property would not appreciate in value during the term of the plan such that the bank would ever receive payment in full of that unsecured claim; rather, the bank would ultimately receive under the plan only about 16% of the present value of its unsecured claim. *Id.* at 28a, 133a.

In addition to ensuring that the debtor would remain in control of the Property — even though the bank's entitlement to receive $93 million in 1995 had been converted into a right to receive payments with a net present value of approximately $60 million over a seven- to ten-year period[3] — the plan of reorganization gave the debtor's pre-bankruptcy equity holders the *exclusive* right to retain their ownership interests in the debtor if they contributed new capital. The cash or cash equivalent portion of the approved new value contribution had a present value of $4.1 million, to be paid over five years. Pet. App. 4a, 24a, 34a, 111a-112a. Only the debtor's pre-petition equity holders were given the opportunity to contribute new capital in exchange for an ownership interest in the reorganized debtor. *Ibid.*; see also *id.* at 21a (recognizing exclusive nature of right of pre-petition equity holders to contribute new value in exchange for post-petition equity interests, and upholding new value exception on that basis).[4]

[3] $54.5 million + (16% of $38.5 million) = $60.66 million.

[4] Exclusivity in this context means that the *plan* did not give anyone other than old equity holders the opportunity to contribute new value for equity in return. It is not to be confused (but see Br. in Opp. 15-17), and the Seventh Circuit did not confuse it, with the defeasible exclusivity of the debtor's right to *propose a plan*. See 11 U.S.C. § 1121(b). All that anyone other than old equity holders can gain if the latter exclusivity is terminated is the right to *ask the judge* to confirm a plan other than that proposed by the debtor, which may allow someone other than old equity holders to bid on the new equity. The judge is still permitted to confirm only one plan, and that plan must still satisfy the requirements of the statute. 11 U.S.C. § 1129(c). Where the judge confirms the debtor's plan, however, the fact remains that old equity holders have been given the exclusive right to obtain new equity by contributing new value. A *confirmed plan* that, without any prior auction, gives old equity holders and only old equity holders the right to buy into the reorganized entity contravenes the plain language of Section 1129(b)(2)(B), we will argue below, because it gives old equity holders "property" "on account of" their prior, junior interest — *whether or not* the bankruptcy judge permitted someone other than the debtor to *propose* a plan, and whether or not such a plan was in fact proposed. Conflating the exclusivity of the ability to propose a plan, on the one hand, and the exclusivity of the ability to purchase interests with new value, on the other, can only confuse matters.

The purpose of the plan of reorganization and the new capital contribution was not to allow the debtor to reorganize its business to return to solvency; the bankruptcy court found that the debtor would *never* become solvent, Pet. App. 133a, and the debtor has admitted that it is "worthless in a balance sheet sense," Br. in Opp. 19.[5] Instead, the plan's principal objective was to enable the debtor's partners to retain ownership of the Property in order to postpone some $20 million in personal tax liabilities; those taxes would be due if the bank were permitted to foreclose. Pet. App. 3a, 112a-113a. The bankruptcy court found that the plan at issue "and indeed, the

[5] At the confirmation hearing on the plan, the evidence showed, and the bankruptcy court found, that the debtor would experience significant cash flow shortfalls in the seventh and eighth years of the plan. Pet. App. 107a, 153a. According to the debtor's own projections, those shortfalls would aggregate approximately $5 million in the seventh and eighth years of the plan. C.A. App. 13, 19. The plan contemplated, and the evidence showed, that the only way the debtor could compensate for the $4.5-$5 million shortfall would be if the bank voluntarily re-lent that amount from the excess cash flow payments it was expected to receive on account of its rewritten secured claim before that time. Pet. App. 153a.

entire bankruptcy case, was filed by the debtor primarily to avoid the severe tax consequences to the debtor's partners of a foreclosure sale of the debtor's property." *Id.* at 112a-113a. The debtor's partners' desire to save $20 million in taxes has thus led to confirmation of a plan that, based on the bankruptcy court's findings, will shortchange the bank by at least $32 million of the amount due in January 1995 *and* deny the bank the right to foreclose and possess the property.

The bank's secured and unsecured claims relating to its $93 million loan were placed in separate classes under the plan. Pet. App. 56a. The bank is by far the debtor's largest creditor; the other unsecured claims held by outside creditors total $90,000, less than ¼ of 1% of the bank's $38.5 million unsecured claim. *Id.* at 3a. Those outside creditors voted to accept the plan; their claims were to be paid in full, without interest, on the effective date of the plan. *Id.* at 3a-4a. The bank, however, voted its secured and unsecured claims to reject the plan. *Id.* at 114a. The bank objected to confirmation on the ground, among others, that the plan violated the absolute priority rule, because the debtor's pre-bankruptcy equity holders had the exclusive right to retain their equity interests in the debtor even though the bank's senior, unsecured claim was not satisfied in full under the plan. *Ibid.*

The bankruptcy court nonetheless confirmed the plan. The court held that, although the plan ran afoul of the absolute priority rule, that rule was limited by the new value exception, which the plan satisfied. Pet. App. 135a-140a. Based on its confirmation of the plan, the bankruptcy court denied the bank's pending motions to convert the case to a Chapter 7 liquidation or dismiss the case, and to grant the bank relief from the automatic stay that begins with the filing of a bankruptcy case, so that the bank could foreclose on the Property. J.A. 13. The district court affirmed the bankruptcy court's decisions. Pet. App. 79a-85a.

C. Proceedings In The Court Of Appeals

A divided Seventh Circuit panel affirmed. Pet. App. 11a-31a. The panel majority held, among other things, that the

absolute priority rule codified at 11 U.S.C. § 1129(b)(2)(B) is subject to a new value exception (or new value "corollary"). Pet. App. 13a-23a. The majority reasoned as follows:

- Section 1129(b)(2)(B) is ambiguous. While "[a]t some level of abstraction," prior equity holders "have the opportunity to invest and to control the company 'on account of' their previous relationship with the debtor * * * Congress, in using the 'on account of' language, might well have intended a more direct causation between the property received by the debtor and the old equity," and thus "even an exclusive right" to participate in the reorganized debtor "is not retained on account of an old equity holder's former ownership interest," but rather "on account of" a new capital contribution. Pet. App. 17a, 21a.
- In light of the perceived statutory ambiguity, the panel majority considered bankruptcy practice before the adoption of the Bankruptcy Code, and concluded that this Court "established" the new value exception in *Case* v. *Los Angeles Lumber*, and that, "for more than fifty years, the new value precept has been recognized as an important corollary or exception to the absolute priority rule." Pet. App. 14a, 19a.
- There is "no question" that Congress "'must have enacted the Code with a full understanding' of the absolute priority rule and its new value corollary." *Id.* at 20a.
- Although "Congress did not explicitly codify the new value corollary" in the Code, the "corollary" "remains a part of our bankruptcy jurisprudence" because "Congress never explicitly declared * * * that it intended the abolition" of the doctrine. *Id.* at 15a, 20a-21a, 23a.

Judge Kanne dissented. To begin with, Judge Kanne explained, "the plain language of the absolute priority rule, *see* 11 U.S.C. § 1129(b)(2)(B)(ii), does not include a new

value exception"; indeed, the statutory text "fails to even hint at" the existence of a new value exception. Pet. App. 32a, 34a. A new value exception is thus inconsistent with "the straightforward text of the statutory absolute priority rule." *Id.* at 38a.

In addition, Judge Kanne concluded that it is not reasonable to assume that Congress implicitly incorporated the new value exception into Section 1129(b)(2)(B)(ii), for two reasons. First, the new value exception rests on a "questionable foundation" under pre-Code law — the dictum in *Case*, which "no reported case expressly adopted * * * as its holding until the Code's enactment in 1978" and which has since "'taken on a life of its own in the lower courts.'" Pet. App. 41a, 42a n.5. Second, the principles underlying the new value exception "differ greatly from those under the present Bankruptcy Code." *Id.* at 42a. Because of "the massive changes in bankruptcy procedures brought on by the Bankruptcy Code," "strict adherence to the pre-Code new value exception might *contravene* Congress's intent in codifying the absolute priority rule" and, at a minimum, does not indicate "Congress's intent to *include* a new value exception in § 1129(b)(2)(B)(ii)." *Id.* at 32a, 40a-41a (second emphasis added).

Only 10 of the 11 judges of the court of appeals considered the bank's request for rehearing *en banc*. Judges Coffey, Easterbrook, Manion, Kanne, and Diane P. Wood voted to grant rehearing *en banc*, but the resultant 5-5 tie led to a denial of rehearing. Pet. App. 48a-49a.

INTRODUCTION AND SUMMARY OF ARGUMENT

Under the Bankruptcy Code, there is no new value exception to the absolute priority rule. A plan of reorganization that relies on any such exception cannot be confirmed. The plain language of the statute does not provide for a new value exception, and there is not an ounce of support for it in the legislative history. Judge Edith Jones aptly described the new value exception when, paraphrasing Gertrude Stein, she observed: "'There is no there there.'" *In re Greystone III Joint Venture*, 995 F.2d 1274, 1282, 1285 (5th Cir. 1992) (dissenting opinion).

For the debtor to prevail in this case, however, it must establish even more than the existence of a new value exception. It must establish that such an exception exists *and allows pre-petition equity holders to retain the* ***exclusive*** *right to obtain a post-petition equity interest in the estate by contributing new value*. The Seventh Circuit squarely endorsed that broad proposition, see Pet. App. 21a, as did the Ninth Circuit in *In re Bonner Mall Partnership*, 2 F.3d 899, 910-911 (1993), cert. dismissed, 513 U.S. 18 (1994). Yet, as we will show, the position of those courts is utterly impossible to square with the statutory language, which in this regard is completely unambiguous. The legislative history and considerations of bankruptcy policy, if anything, only reinforce the conclusion that is inescapable from the statutory text.

Because it would be sufficient for reversal if this Court were to accept our submission that pre-petition equity holders may not be given the exclusive opportunity to bid new value for new equity, the Court in this case is not required to address the broader argument — made by Solicitor General Fried in his *Ahlers* amicus brief and again by Solicitor General Days in his *Bonner Mall* amicus brief — that "the language and structure of the Code prohibit in all circumstances confirmation of a plan that grants the prior owners an equity interest in the reorganized debtor over the objection of a class of unpaid unsecured claims." Br. for the United States as Amicus Curiae, *Bonner Mall*, at 14.[6] Because old equity holders

[6] We concede that the argument that pre-petition equity holders enjoy their post-petition interest "on account of" their prior interests loses much of its force when an open auction is held and pre-petition equity holders prevail over all other bidders, including creditors. The separate question whether the bankruptcy court has the authority to hold such an auction, however — particularly on its own motion and not in the context of a plan that sets forth in detail the procedures that will purportedly govern any such "auction" — raises issues involving construction of a number of different provisions of the Code. Because no auction was held or proposed in this case, however, the question is not before the Court.

received the exclusive right to bid on new equity in this case, however, the Court need not reach the broader issue.

I. Section 1129(b)(2)(B)(ii) provides, in no uncertain terms, that the absolute priority rule is, in fact, to be absolute: junior classes (such as existing stockholders) are not to receive "any property" under a plan of reorganization "on account of" their pre-bankruptcy interests until senior classes of unsecured creditors are provided for in full. An option to become an owner of a business enterprise is undoubtedly "property," a term that is defined broadly in the Code. And that property is received "on account of" a prior interest when, as in this case, a plan gives pre-bankruptcy equity holders an *exclusive* opportunity to obtain a stake in the reorganized debtor — everyone except the prior equity owners is disqualified from having an opportunity to invest in the post-bankruptcy enterprise.

The broad language that Section 1129(b) uses in stating the absolute priority rule is not limited or qualified anywhere in the Code. Most importantly for purposes of this case, the Code does not contain a single reference to a new value exception. Congress listed the ways in which a plan can be crammed down on unconsenting creditors, but a new value exception is not among them.

II. Given the clarity with which Congress spoke in Section 1129(b), there is no need to turn to legislative materials. But the legislative history reinforces what is already clear from the unambiguous text of the statute: there is no new value exception. There is not a shred of support for a new value exception in the legislative history — no such exception is even mentioned, let alone endorsed — and, in fact, the committee reports and statements by floor leaders consistently described the Code's absolute priority rule as mandating that junior interests cannot receive anything at all under a plan of reorganization until senior classes of unsecured creditors are paid in full.

III. There is certainly no basis for interpreting congressional "silence" as tacit acceptance of well-settled pre-Code

law concerning a new value exception. Congress was far from silent. There was no well-settled pre-Code law of any sort on any new value question. And any new value exception that may have existed (as well as the absolute priority rule that did exist) under pre-Code law addressed circumstances wholly different from those presented today.

Notwithstanding decisions of this Court construing *ambiguous* Code provisions by reference to pre-Code law coupled with "silence" in the legislative history, it is a misunderstanding of the highest order to equate silence in the legislative history with *congressional* silence. Congress speaks through statutes; individual Members and Committees speak through legislative history. Congress spoke with more than sufficient clarity (and unquestionably changed pre-Code law in critical respects) in the *text* of Section 1129. It would flout, not further, the will of the Legislature to give that language an unnatural reading because no Member or Committee said in legislative history "we intend to change not only the pre-Code absolute priority rule, but also this particular aspect of the pre-Code absolute priority rule."

In addition, the pre-Code practice that the Seventh Circuit would have "silence" ratify rests on the shakiest of legal foundations: dicta from *Case* v. *Los Angeles Lumber* that had never been adopted as the holding of *any* reported decision before enactment of the Bankruptcy Code. It is certainly understandable that Congress would not feel any need to repudiate those dicta any more expressly than it did.

What is more, the legal landscape that prompted the suggestion of a new value exception during the Great Depression and New Deal era is fundamentally different from the law of bankruptcy that exists today. The Bankruptcy Code completely revamped the law of reorganization, creating an entirely new framework that is an amalgam of concepts derived from the various statutory schemes that preceded it. Most important among the many pertinent changes is the possibility under the Code, which did not exist under pre-Code law, of confirming a new-value (or any other) reorganization plan through the *consent* of creditors, acting as classes. In light of

the changes reflected in Chapter 11, it makes no sense to presume that Congress implicitly intended to incorporate an exception to the absolute priority rule that was proposed in the context of a vastly different bankruptcy statute.

IV. A new value exception is flatly inconsistent with the policy that is at the heart of the Bankruptcy Code: in recognition that equity is to bear the greatest risk of loss in exchange for enjoying a business's upside potential, the interests of creditors take precedence over the interests of an insolvent debtor's equity holders. The new value exception contravenes that policy by permitting an insolvent debtor's insiders — who no longer have any economic interest in the debtor's property — to grant themselves the exclusive opportunity to obtain interests in the reorganized property without having to worry about competitive bids from creditors or outsiders. This permits the debtor's insiders effectively to sell the debtor's property to themselves on their own chosen terms, checked only by a bankruptcy judge's necessarily imperfect attempt at valuation. No provision under Chapter 11 of the Bankruptcy Code permits this type of judicially sanctioned insider self-dealing, and case law under other Bankruptcy Code provisions such as Section 363 expressly condemns it. The effect of a new value exception — permitting those at the bottom of the priority ladder to control the debtor's property to the detriment of impaired creditors with a higher priority — turns the absolute priority rule on its head.

A new value exception also requires the courts to make business decisions that properly belong to the creditors. The exception permits courts to force creditors to waive the absolute priority rule, but under the Code that decision is solely for the creditors themselves to make. The Code does not give courts the power to tell senior impaired creditors that they have misperceived their own best interests.

ARGUMENT

The new value exception has been aptly described as a square peg in a round hole. Salvatore G. Gangemi & Stephen Bordanaro, *The New-Value Exception: Square Peg in a Round Hole,* 1 AM. BANKR. INST. L. REV. 173 (1993). It does not fit the language of the Code. It finds no support in the legislative history. It cannot reliably be imported from pre-Code law into the structure of the Code, which differs in crucial respects. And it contravenes fundamental bankruptcy policy.

I. THE PLAIN STATUTORY LANGUAGE DOES NOT INCLUDE A NEW VALUE EXCEPTION

The Bankruptcy Code does not contain a single reference to a new value exception. Instead, the Code simply adopts the absolute priority rule without limitation: Unless a plan of reorganization provides for payment in full to a dissenting, senior class of unsecured creditors, a plan cannot be confirmed if a junior class of unsecured creditors or equity interest holders "receive[s] or retain[s] under the plan on account of such junior claim or interest *any property*." 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added). As we explain below, that unequivocal language, combined with the absence of any textual support for an exception, compels the conclusion that the Bankruptcy Code does not contain a new value exception to the absolute priority rule.

1. The right provided to the debtor's pre-petition owners by the plan here — the exclusive opportunity to retain an equity interest in a business enterprise — certainly is "property" within the meaning of Section 1129(b). "[W]hile the Code itself does not define what 'property' means as the term is used in § 1129(b), the relevant legislative history suggests that Congress' meaning was quite broad," and included "'both tangible and intangible property.'" *Ahlers*, 485 U.S. at 208 (quoting H.R. Rep. No. 95-595, at 413 (1977)).[7]

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[7] Indeed, the Court held in *Ahlers* that an equity interest in a debtor is "property" for purposes of Section 1129(b) even if that equity interest is "worthless" and "has no value to the senior unsecured creditors." 485 U.S. at 207. The Court explained (*id.* at 207-208, quoting *Northern Pac. Ry.* v. *Boyd*, 228 U.S. 482, 508 (1913)):

> Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains "property." Whether the value is "present or prospective, * * *

The Second and Fourth Circuits have correctly relied on this broad definition of property in holding that "the *exclusive* right to retain the debtor's property upon making a capital contribution" is "property" within the meaning of Section 1129(b) — and that a plan including such a provision violates the absolute priority rule. *In re Coltex Loop Central Three Partners, L.P.*, 138 F.3d 39, 43 (2d Cir. 1998); *In re Bryson Properties*, 961 F.2d 496, 504 (4th Cir. 1992) (the "exclusive right to contribute [new capital] constitutes 'property' under § 1129(b)(2)(B)(ii), which was received or retained on account of a prior interest").[8] Even courts holding that a new value exception exists have agreed that the exclusive opportunity to obtain an ownership interest in an enterprise is "property" under Section 1129(b). See Pet. App. 17a; *Bonner Mall*, 2 F.3d at 910 n.27. But see Pet. App. 21a (dismissing this understanding of "property" as "highly conceptualistic"). The same type of property interest is involved here.

2. The "cardinal canon" of statutory construction is that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-254 (1992). Thus, when a statute is unambiguous, judicial inquiry begins

or only for purposes of control," a retained equity interest is a property interest to "which the creditors [are] entitled * * * before the stockholders [can] retain it for any purpose whatever."

[8] See also, *e.g.*, *Kham & Nate's Shoes No. 2, Inc.* v. *First Bank*, 908 F.2d 1351, 1360 (7th Cir. 1990) (Easterbrook, J.) ("[a]n option to purchase stock also is 'property'" under § 1129(b)); *In re Lumber Exchange*, 125 B.R. 1000, 1008 (Bankr. D. Minn.) ("A special opportunity or right afforded to members of a class of equity security holders to retain or acquire an equity position in a reorganized debtor through a new cash contribution under a plan is, by its very nature, the opportunity or right to receive or retain property on account of the prepetition interest held."), aff'd, 134 B.R. 354 (D. Minn. 1991), aff'd, 968 F.2d 647 (8th Cir. 1992); BAIRD, *supra*, at 261 ("The right to get an equity interest for its fair market value is 'property' as the word is ordinarily used. Options to acquire an interest in a firm, even at its market value, trade for a positive price. They are bought and sold every day.").

and ends with "the words of [the] statute." *Id.* at 254. In a case involving interpretation of the Bankruptcy Code, no less than any other statute, when "the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States* v. *Ron Pair Enterprises*, 489 U.S. 235, 241 (1989) (quoting *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917)).

The statute at issue here is unambiguous. Section 1129(b)(2)(B)(ii) states that a plan that does not provide a dissenting class of unsecured creditors with property of a value, as of the effective date of the plan, equal to the amount of their claims *cannot* be confirmed unless "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest *any property*." (Emphasis added.) The language is unequivocal; it does not allow a junior class to receive "any" property "on account of" its pre-petition interest unless senior classes are provided for in full.

This Court has regularly construed broadly written Bankruptcy Code provisions expansively, in accordance with their plain meaning.[9] That approach should be followed here as well. The Court must presume that Congress expressed its intent in stating, in the broadest conceivable terms, that junior classes were barred from receiving "any" property because of their pre-bankruptcy interests in the debtor unless senior creditors are provided for in full. Even if it were doubtful that Congress had the new value exception in mind when it wrote such a broad prohibition, that would not matter. "As we

[9] See *Patterson* v. *Shumate*, 504 U.S. 753, 757-758 (1992) (statutory phrase "applicable nonbankruptcy law" encompasses state and federal law); *Union Bank* v. *Wolas*, 502 U.S. 151, 154-156 (1991) ("debt" includes long-term and short-term debt); *Toibb* v. *Radloff*, 501 U.S. 157, 160-161 (1991) (Code provision allowing a "person" to file a Chapter 11 proceeding includes nonbusiness individual debtors); *Pennsylvania Dep't of Public Welfare* v. *Davenport*, 495 U.S. 552, 557-560 (1990) ("debt" includes restitution orders); *Ron Pair*, 489 U.S. at 241-242 ("[r]ecovery of postpetition interest is unqualified" in § 506 of the Code, and thus Congress did not distinguish between consensual and nonconsensual liens).

have said before, the fact that a statute can be '"applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth."'" *Pennsylvania Dep't of Corrections* v. *Yeskey*, 66 U.S.L.W. 4481, 4483 (U.S. June 15, 1998).

Nor is there the slightest indication in the statute that the sweeping prohibition on the receipt of "any" property by junior classes is qualified by any type of exception or limitation, much less a new value exception. As even Judge Reinhardt, writing for the court, conceded in *Bonner Mall*, "a textual search for a 'new value exception' to the absolute priority rule dictates its own negative result because such a statutory exception *does not exist*." 2 F.3d at 909 n.25 (emphasis added). That should be the end of the matter. The Bankruptcy Code simply does not contain a new value exception — and this Court should not add statutory provisions that Congress did not enact. See *Bates* v. *United States*, 118 S. Ct. 285, 290 (1997) ("we ordinarily resist reading words or elements into a statute that do not appear on its face"); *62 Cases* v. *United States*, 340 U.S. 593, 596 (1951) (Frankfurter, J.) ("Congress expresses its purpose by words. It is for us to ascertain — neither to add nor to subtract, neither to delete nor to distort.").[10]

3. The court below, and other supporters of a new value exception, have attempted to find ambiguity in the statutory language through two devices. The first is the purest

[10] Section 1129(b) provides that the condition that a plan be "fair and equitable * * * *includes* the following *requirements*" (emphasis added). One of the requirements that follows is the absolute priority rule. The word "includes" does not leave room for a new value exception. The "requirements" set forth in Section 1129(b) are the *minimum* prerequisites that must be satisfied before a court may confirm a plan of reorganization. See *In re D&F Constr., Inc.*, 865 F.2d 673, 675 (5th Cir. 1989). The "includes" provision thus permits a court to impose *additional* requirements, but it is not a license to *dilute* requirements that Congress expressly set forth in the statute. "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Ahlers*, 485 U.S. at 206.

bootstrapping: because courts and commentators have differed about whether the new value exception exists, there *must* be ambiguity. See, *e.g.*, Pet. App. 18a-19a. But that one-way ratchet, which renders the Bankruptcy Code more and more ambiguous whenever courts purport to find ambiguity in it leading to different constructions, is the path to interpretive chaos — not just in this case, but in every case involving an issue of even the slightest difficulty under the Code. Moreover, this approach cannot be reconciled with this Court's decisions. In *Ron Pair*, for example, the majority held that the Code provision at issue was unambiguous even though four Justices thought that the better construction was the one rejected by the majority. As Judge Kanne rightly pointed out, *all* of this Court's bankruptcy decisions "command courts to apply a statute's unambiguous language without looking beyond it." Pet. App. 38a.

The second argument often advanced to try to fit the new value exception within a statute that does not "even refer to[ ] the new value exception," *Bonner Mall*, 2 F.3d at 909, is that the equity holders' post-petition interest is not received or retained "on account of" their pre-petition interest but rather "on account of" the new value they contribute. See, *e.g.*, Pet. App. 17a, 21a. New value proponents acknowledge that, "[a]t some level of abstraction, the new investors in the plan can be said to have the opportunity to invest and to control the company 'on account of' their previous relationship with the debtor." *Id.* at 17a; see also *Bonner Mall*, 2 F.3d at 909 ("in some larger sense the reason that former owners receive new equity interests in reorganized ventures is that they are former owners"). But they contend that a "more direct" reason for the retained equity interest is the contribution of new value. Pet. App. 17a. This argument suffers from two flaws.

First, it ignores the text of the statute, which instructs courts to determine whether "any property" is received "on account of" a junior interest. Backers of a new value exception shift the focus from the property interest at issue — the exclusive opportunity to obtain an equity stake in the reorganized debtor — to the ownership interest ultimately purchased

as a result of exercising that property right. But when the interpretive focus is *not* on the purchased equity interest, but instead, as the statute requires, is on the property interest provided by the plan (the *exclusive right* to share in ownership of the debtor), the conclusion is inescapable that the pre-bankruptcy equity holders are receiving property "on account of" their pre-bankruptcy interests.

The Seventh Circuit's response to this point was to belittle as "highly conceptualistic" the "suggestion that the opportunity to participate in the reorganization is itself property retained on account of an old equity holder's prior ownership interest." Pet. App. 21a. Conceptualistic or not, however, that is no mere suggestion: it is the square *holding* of this Court in *Ahlers*, 485 U.S. at 207-209, construing the term "property" in the very statute at issue here. The Seventh Circuit was not at liberty to depart from this Court's unanimous *Ahlers* decision by redefining "property" in a way it regarded as less "conceptualistic." Moreover, it is the Seventh Circuit that has sacrificed the practical to the conceptual by attempting to discern "a more direct causation" that "Congress * * * might well have intended." Pet. App. 17a. The very essence of any policy argument in favor of a new value exception (other than naked pro-debtor sympathy) is that, *as a practical matter*, old equity holders *as such* must be given the opportunity to participate in a reorganization by contributing new value.[11] Whatever one thinks of that argument as a policy matter, it is simply disingenuous to pretend that old equity holders are not getting special treatment "on account of" their old equity interests.

The Seventh Circuit's related statement that, "[a]s a practical matter, the opportunity to participate in a reorganization plan, even an exclusive right, is not retained on account of an old equity holder's prior ownership interest," Pet. App. 21a,

[11] See, *e.g.*, Charles W. Adams, *New Capital for Bankruptcy Reorganizations: It's the Amount that Counts*, 89 NW. U.L. REV. 411, 426 (1995) ("the Court should recognize the exception, because an insolvent corporation's former owners are often the only feasible source of new capital, and their contributions should be encouraged, rather than barred").

is mere *ipse dixit*. And it is *ipse dixit* with an Alice-in-Wonderland quality at that, considering that the Seventh Circuit in the very same paragraph asserted that "exclusivity may be necessary simply because it may be easier to obtain additional funding from the old equity participants." *Ibid.* One cannot, with any intellectual coherence, simultaneously praise special treatment for old equity holders as a policy matter and deny that such special treatment renders the participation "on account of" old equity holders' status as such. See Michael H. Strub, Jr., *Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of Bonner Mall*, 111 BANKING L.J. 228 (1994); see also Miller, *supra*, 77 B.U. L. REV. at 1008-1009 ("This preference, this blatant diversion of property and benefits by shareholders to shareholders, arises only on account of their shareholder status in the corporation before reorganization.").

Second, the "on account of" argument mistakenly assumes that there is an inconsistency between occurring "on account of" one thing and *also* occurring "on account of" something else. For example, Justices sit on this Court "on account of" *both* appointment by the President and confirmation by the Senate. To assert that they do not enjoy their positions "on account of" appointment by the President, just because senatorial confirmation is also necessary, would be absurd. It is equally meaningless to say that a Justice sits on this Court "primarily" because of either appointment by the President or confirmation by the Senate. When an event has two absolute prerequisites, labeling one or the other as "primary" cannot possibly aid analysis.

To take another example, mixed motives are quite familiar in the law of employment discrimination. See, *e.g.*, *Price Waterhouse* v. *Hopkins*, 490 U.S. 228 (1989). Cases where an employer took adverse action "because of * * * sex" and also for more legitimate reasons present many vexing questions, but no one would be so bold as to claim that the illicit motivation can be *completely ignored* just because the adverse action was also taken "because of" something else. See *ibid.*; see also *Oncale* v. *Sundowner Offshore Services, Inc.*, 118

S. Ct. 998, 1003 (1998) (Thomas, J., concurring) ("the Court stresses that in every sexual harassment case, the plaintiff must plead and ultimately prove Title VII's statutory requirement that there be discrimination 'because of . . . sex.'"); *McKennon* v. *Nashville Banner Co.*, 513 U.S. 352, 360 (1995) ("[m]ixed-motive cases" are apposite "to the important extent [that] they underscore the necessity of determining the employer's motives in ordering the discharge"). So too in this case. The equity holders enjoy their post-petition interest under the plan "on account of" *both* their prior equity positions and their promise to contribute new value.

This violates the plain language of the absolute priority rule. It does not matter that there are two reasons why a prior equity holder is able to retain an ownership interest in the post-bankruptcy enterprise. The statute does not require a court to determine (nor could a court rationally determine) "whether a reorganization plan that gives stock to former equity holders does so *primarily* * * * 'on account of' old equity's prior ownership or 'on account of' its new contribution." *Bonner Mall*, 2 F.3d at 909 (emphasis added). As Judge Kanne explained, for that type of inquiry to be warranted by Section 1129(b), one would have to insert into the statute "the words 'solely or primarily' before 'on account of.'" Pet. App. 36a. And "[f]or the court to add such modifiers would work a significant and unwarranted change in the meaning and consequence of the statute." *Coltex*, 138 F.3d at 43. Thus, a plan violates Section 1129(b) if *one* reason a pre-petition equity holder obtains an ownership stake in the debtor is "on account of" the prior interest, which it unquestionably is when old equity holders' right is exclusive.[12]

[12] This straightforward reading of Section 1129(b)(2)(B)(ii) does not prevent pre-petition equity holders from ever receiving or retaining a post-bankruptcy interest in a debtor and thus, contrary to Judge Reinhardt's claim in *Bonner Mall*, 2 F.3d at 909, does not render the "on account of" language "superfluous." "If prior equity holders earn their shares in an open auction, for example, their reserved interests would not be 'on account of' their junior interests but on account of their capital contributions." Pet. App. 36a (Kanne, J., dissenting). In addition, creditors are free to consent, as they often do (and did, then to no avail, in *Case*), to plans that allow prior equity owners to retain an interest in the post-bankruptcy debtor. See *id.* at 47a n.7 and cases cited there. An equity interest holder also may hold senior claims against the debtor and might receive equity interests in the reorganized debtor under the plan "on account of" those senior claims and thus, not "on account of" its equity interests.

In these circumstances, the debtor's pre-petition equity holders are receiving a property right not available to anyone else, and they are getting that *exclusive* opportunity *solely* "on account of" their prior equity interests in the debtor — that is the distinguishing characteristic that entitles them to preferential treatment. In this case, for example, prior equity holders are the *only* persons permitted under the plan to make such an investment; other persons are barred from doing so, no matter how much capital they might be willing to invest in the post-petition debtor. And the debtor's partners

> receive this *exclusive* ownership right *only* "on account of" their unique status as prior equity holders. The Plan's grant of this *exclusive* right to [the debtor's] partners thus provides a *necessary* element that causes the prior equity holders to retain their junior interests before the satisfaction of Bank America's deficiency claim.

Pet. App. 34a (Kanne, J., dissenting); see also *Coltex*, 138 F.3d at 44 ("the Partners could not have gained their new position but for their prior equity position"); *Greystone*, 995 F.2d at 1283, 1285 (Jones, J., dissenting) ("Greystone intends to prevent creditors from acceding to ownership of the property on account of Greystone's unique status as an old equity contributor to the plan").[13]

[13] Judge Kanne noted that "[t]he motivations of [the debtor's] partners magnify this point." Pet. App. 34a. The only reason they contributed new capital was to postpone $20 million in individual tax liabilities that would be assessed if the bank were permitted to foreclose. In other words, "the presence of (and the potential tax liability inherent in) the partners' prior equity interests motivated the Plan's inclusion of the partners' exclusive right to retain their equity interests." *Id.* at 35a.

4. In finding the statute ambiguous, the panel majority relied in part on the notion that past bankruptcy practice cannot be disregarded "absent a clear indication that Congress intended to break from those practices." Pet. App. 20a. As discussed at pp. 26-32, 33-36, *infra*, the majority's premise is faulty. There was no settled pre-Code practice holding that new value plans were permissible, and, in fact, the legislative history indicates that Congress intended the absolute priority rule to be *absolute*.

But while all of that provides further support that Section 1129(b)(2)(B)(ii) means what it says, it is unnecessary to consider either the legislative history or the pre-Code practice. "[T]he clarity of the statutory language at issue in this case obviates the need for any such inquiry." *Patterson*, 504 U.S. at 761. Indeed, this Court has stressed that the unambiguous words of the Bankruptcy Code must be applied even when the statute changes established pre-Code practice. See *Dewsnup* v. *Timm*, 502 U.S. 410, 419-420 (1992) ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling."); *Toibb*, 501 U.S. at 162 (there is "no need" to examine legislative history unless "'the statutory language is unclear'") (quoting *Blum* v. *Stenson*, 465 U.S. 886, 896 (1984)); *Davenport*, 495 U.S. at 563-564 (1990) (enforcing plain meaning of Bankruptcy Code provision even though it abrogated pre-Code practice).

All of this accords with settled principles. "[L]egislative history need not confirm the details of changes in the law effected by statutory language before we will interpret that language according to its natural meaning." *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 385 n.2 (1992); see also, *e.g.*, *Toibb*, 501 U.S. at 164 (because of "the plain language of the statute," it "makes no difference whether the legislative history affirmatively reflects [congressional] intent"); *Yeskey*, 66 U.S.L.W. at 4483 (even if Congress did not envision a particular application of a statute, "in the context of an unambiguous statutory text that is irrelevant"); *Bourjaily* v. *United States*, 483 U.S. 171, 178 (1987) ("[i]t would be extraordinary to require legislative history to *confirm* the plain

meaning of [a federal statute]," even when Congress has changed existing law); *Almendarez-Torres* v. *United States*, 118 S. Ct. 1219, 1241 n.6 (1998) (Scalia, J., joined by Stevens, Souter & Ginsburg, JJ., dissenting) (quoting *Morales*). That principle is particularly important here because the Bankruptcy Code, nearly a decade in the making, effected "such a substantial overhaul of the system." *Ron Pair*, 489 U.S. at 240. Under the circumstances,

> it is not appropriate or realistic to expect Congress to have explained with particularity each step it took. Rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.

Id. at 240-241.[14]

* * *

Had Congress wanted to include a new value exception in the Bankruptcy Code, it could have done so easily. It did not. See Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 536 (1947) (in interpreting a statute, "[o]ne must * * * listen attentively to what it does *not* say") (emphasis added). Courts "must enforce the statute according to its terms," *Patterson*, 504 U.S. at 759, and by its terms, the Bankruptcy Code simply does not include a new value exception to the absolute priority rule — certainly not one broad enough to allow the pre-petition

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[14] Having made no mention of any new value exception in the statute, Congress, of course, provided no guidance as to the content of any such exception. Any such development, therefore, must occur entirely in the courts. But Congress knows how to say when it intends such judicial development of the content of a Bankruptcy Code provision. See, *e.g.*, 124 Cong. Rec. 32,398 (1978) ("It is intended that the term 'principles of equitable subordination' [in 11 U.S.C. § 510(c)] follow existing case law and leave to the courts development of this principle.") (statement of Rep. Edwards); *id.* at 33,998 (same) (statement of Sen. DeConcini). That Congress did not do so here reinforces the conclusion that it intended the codified absolute priority rule to be enforced as written, not to be subject to an exception — uncodified and unmentioned in the legislative history — to be developed by the courts.

equity holders to enjoy the exclusive right to contribute new value that they were accorded here.

II. THE LEGISLATIVE HISTORY SHOWS THAT CONGRESS DID NOT PROVIDE FOR A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE

"Given the clarity of the statutory text, respondent's burden of persuading [the Court] that Congress intended to create *or to preserve* a special rule" in accordance with supposed pre-Code practice "is *exceptionally heavy*." *Wolas*, 502 U.S. at 155-156 (emphasis added). A statute's "plain meaning" is ordinarily "conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'" *Ron Pair*, 489 U.S. at 242 (quoting *Griffin* v. *Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)). This is not one of those rare cases. There is no "'clearly expressed legislative inten[t] * * * contrary' to the plain language" of Section 1129(b)(2)(B)(ii). *Toibb*, 501 U.S. at 162 (quoting *Consumer Product Safety Comm'n* v. *GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)). The legislative history, in fact, reinforces the clear import of the statutory text: there is no new value exception to the absolute priority rule.

1. Before enactment of the Bankruptcy Code, bankruptcy proceedings were governed by the Bankruptcy Act of 1898, which contained three rehabilitative chapters, Chapters X, XI, and XII. See generally Pet. App. 42a-43a (Kanne, J., dissenting). Each chapter differed from the others with respect to the standards that had to be met to confirm a plan over a dissenting class of unsecured claims. Chapter X (and its predecessor, Section 77B) authorized a court to approve a plan only if it was "fair and equitable," but the statute did not define that phrase. *Case*, 308 U.S. at 114-115. Chapter X, as construed by the Court, also imposed the "fair and equitable" requirement even in cases of creditor consent: "where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes of security holders required by § 77B, sub. f for confirmation of the plan has consented." 308 U.S. at 114. It was against this backdrop, in the course of elucidating the meaning of the "fair and equitable" requirement, that Justice Douglas suggested that there might be a judicially created exception to the absolute priority rule. *Id.* at 114-121.

Two other business rehabilitative chapters also existed before adoption of the Bankruptcy Code. Under Chapter XI, as amended in 1952, there was no "fair and equitable" requirement; thus, the absolute priority rule did not apply in Chapter XI proceedings, and "cases under that chapter did not address any new value issues." Pet. App. 43a n.6 (Kanne, J., dissenting). Chapter XII, which dealt with real estate reorganizations, also "did not require that a plan conform to the absolute priority rule" after the statute was amended in 1952, and thus new value issues never arose under Chapter XII either. Gangemi & Bordanaro, *supra*, 1 AM. BANKR. INST. L. REV. at 188 & n.106.

2. In 1973, five years before adopting the Code, Congress considered comprehensive bankruptcy legislation that, among other things, proposed "modify[ing] the absolute priority rule to permit equity holders to participate in a reorganized enterprise based on their contribution of 'continued management * * * essential to the business' or other participation beyond 'money or money's worth.'" *Ahlers*, 485 U.S. at 205 (quoting H.R. Doc. No. 93-137, pt. 1, at 258-259 (1973)). This proposal "prompted adverse reactions from numerous sources," and Congress rejected it. *Ibid.*; see also J. Ronald Trost & Lawrence P. King, *Congress and Bankruptcy Reform Circa 1977*, 33 BUS. LAW. 489, 553-556 (1978).

Some opinions view this as congressional repudiation of a new value exception. *E.g.*, *Kham & Nate's Shoes*, 908 F.2d at 1361-1362. Others interpret these events as endorsement of what they incorrectly perceive to have been the status quo, including the dicta in *Case*. *E.g.*, *In re Snyder*, 967 F.2d 1126, 1130 (7th Cir. 1992).[15] All of this is speculation; the legisla-

[15] Of course, it is indisputable that Congress changed the absolute priority rule itself — by making it apply only in the absence of creditor *con-*

tive materials give no indication *why* Congress rejected the 1973 legislation. As a result, this earlier proposal sheds little light on the question presented in this case.

3. The legislative history of the statute actually enacted in 1978 is much more revealing. To begin with, in discussing then-current law, Congress described the absolute priority rule, as applied under Chapter X of the Bankruptcy Act of 1898, as a rigid requirement and did not even suggest the existence of a new value exception, much less congressional acceptance of such an exception. In fact, there is not a single reference to a new value exception to the absolute priority rule in either the House Report or the Senate Report, S. Rep. No. 95-989 (1978). Rather, the House Report summarized the law under Chapter X as follows:

> Chapter X requires application of the absolute priority rule as a standard for confirmation of a plan. Under that rule, senior creditors *must be paid in full* under the plan *before* junior creditors or *stockholders may receive anything*.

H.R. Rep. No. 95-595, at 222 (emphasis added).[16]

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sent — in 1978. That change is so radical that it would have required a ruling *against the objecting creditors* in *Case*, which was decided in those creditors' favor. See BAIRD, *supra*, at 262. It is unclear how anyone could think that the "status quo" supposedly ratified by congressional inaction included an exception to a rule that did not exist in its present form until 1978. See Miller, *supra*, 77 B.U. L. REV. at 1012-1013 ("Congress clearly and explicitly revolutionized bankruptcy law by opening the door to shareholder participation over the objection of dissenting creditors who were part of accepting classes, thereby preventing one or two dissatisfied creditors from foiling a feasible reorganization plan.") (footnote omitted).

[16] Similarly, neither Representative Don Edwards nor Senator Dennis DeConcini — the managers of the legislation, see *Ron Pair*, 489 U.S. at 243 n.6 — mentioned a new value exception at all in their statements about the bill. See 124 Cong. Rec. 34,128 (1978); *id.* at 33,990-34,019; *id.* at 32,350-32,420; *id.* at 28,257-28,284; *id.* at 1799; 123 Cong. Rec. 36,095 (1977); *id.* at 35,642-35,693; *id.* at 35,444-35,457.

Congressional statements about the legislation that ultimately became the Bankruptcy Code also indicate that Congress intended to adopt an absolute priority rule that did not include any exceptions. It replaced the court-centered Chapter X, which required application of the absolute priority rule even when all classes of creditors had consented to a plan, with a party-centered Code providing creditors and debtors with substantially more autonomy. The cramdown provisions, making a court resolve the parties' differences, were a substantially less favored alternative than consented-to plans.[17] This was wholly intentional and was arguably the centerpiece of the entire reorganization reform that took place in 1978:

> The premise of the bill's financial standard for confirmation is the same as the premise of the securities law: *parties should be given adequate disclosure of relevant information, and they should make their own decision on the acceptability of the proposed plan of reorganization*. The bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. It is unrealistic to assume that the bill could or even should attempt to answer that question. *Instead, negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders*. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value.
>
> *Only when the parties are unable to agree on a proper distribution of the value of the company does the bill*

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[17] In this respect, the Bankruptcy Code stemmed from the same policies of increased reliance on negotiation and market forces, and decreased reliance on courts and regulators, that underlay the entire (and wildly successful) movement of deregulatory reform in the 1970s. See generally STEPHEN G. BREYER, REGULATION AND ITS REFORM (1982); ALFRED E. KAHN, THE ECONOMICS OF REGULATION xv-xxxvii (2d ed. 1988) (Introduction: A Postscript, Seventeen Years After).

> *establish a financial standard.* * * * * The rule is a ***partial application*** of the absolute priority rule now applied under chapter X and requires a full valuation of the debtor as the absolute priority rule does under current law. The important difference is that the bill *permits* senior classes [*i.e.*, by consent] to take less than full payment, in order to expedite or insure the success of the reorganization.

H.R. Rep. No. 95-595, at 224 (emphasis added and footnotes omitted).

This legislative history powerfully supports the proposition that the Code provides a way for new-value plans to succeed that pre-Code law did not. But the mechanism the Code provides for such plans is *not* the one postulated by the court below: cramdown of such a plan on unconsenting creditors. Rather, consistent with the overall thrust of the Code, shareholders must persuade creditors to *consent* to a new-value plan, or the plan must honor the absolute priority rule.[18] There is no third alternative.

The House Report further elaborated with a straightforward statement of the absolute priority rule, with no mention of an exception:

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[18] As Professor Miller has written (77 B.U. L. REV. at 1009-1010):

> Negotiation between creditors and the debtor is the hallmark of Chapter 11. Under consent receivership and the Act, the absolute priority rule reigned supreme: a creditor could not waive application of the absolute priority rule even if that creditor wanted to. New value represented the only legitimate avenue for shareholder participation in the reorganization of an insolvent debtor. By comparison, under the Code, the absolute priority rule does not apply where all classes of creditors and shareholders accept the plan. Thus, the Code not only allows, but encourages, shareholder participation with or without a new value contribution. * * * This ability to agree on a means for raising capital vitiates the need for the new value exception as announced in *Case*. * * * Because the absolute priority rule vanishes with the creditors' agreement, the new value exception drops out as dysfunctional and irrelevant. [Footnotes omitted.]

> If [the dissenting impaired class] is paid in full, then junior classes may share. * * * [I]f the class is impaired, then they must be paid in full or, if paid less than in full, then *no class junior may receive anything* under the plan. This codifies the absolute priority rule from the dissenting class on down.

H.R. Rep. No. 95-595, at 413 (emphasis added); see also *id.* at 416 (when a dissenting, impaired class of unsecured creditors receives less than full value under the plan, the plan may be confirmed "if junior classes will receive *nothing* under the plan") (emphasis added); *Kham & Nate's Shoes*, 908 F.2d at 1362 ("[n]either the [House] report nor any part of the text of the Code suggests a single exception" to the "blanket rule" of absolute priority).

The statements made by the bill's floor leaders, when presenting the legislation for final approval after a conference committee agreed on the final text of the bill, provide further evidence that Congress intended to adopt an *absolute* priority rule, one that did not contain any exceptions. Representative Edwards told the House that a plan could be confirmed over the objections of a dissenting class of impaired unsecured creditors "as long as no class junior to the dissenting class receives *anything at all*." 124 Cong. Rec. 32,408 (1978) (emphasis added). Senator DeConcini made the same statement to his colleagues. *Id.* at 34,007.[19]

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[19] In addition, Representative Edwards and Senator DeConcini each noted that, "[a]lthough many of the factors interpreting 'fair and equitable' are specified in paragraph (2)" of Section 1129(b), "others, which were explicated in the description of section 1129(b) in the House report, were omitted" from the final bill "to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable' treatment of a dissenting class," such as the requirement that no senior class receive more than 100% of the amount of its claims. 124 Cong. Rec. 32,407 (1978); *id.* at 34,006. A new value exception was not one of the other factors "explicated * * * in the House report"; the Report does not even mention a new value exception in its description of Section 1129(b). See H.R. Rep. No. 95-595, at 413-418. Rather, as noted in the text, the Report states consistently that a plan cannot be confirmed when a senior class has not been provided for in full unless junior classes

* * *

The legislative history shows that Congress intended to codify the absolute priority rule without a new value exception. Even if it did not do so, however, application of the plain language of Section 1129(b) would still be warranted given the complete absence of *any* reference to, let alone *affirmative* support for, a new value exception in the Code's legislative history. This void in the legislative history distinguishes this case from *Dewsnup*, where there was legislative history indicating specifically that Congress intended the pre-Code practice to survive. 502 U.S. at 419. When the statutory text gives no indication that Congress intended to codify pre-Code law and the legislative history "does not even mention" the pre-Code practice, the Court must enforce the plain language of the statute. *Wolas*, 502 U.S. at 159 & n.14 (1991). As we have already explained, Section 1129(b) by its terms does not, expressly or by any implication, provide for a new value exception.

III. CONGRESS DID NOT ADOPT THE NEW VALUE EXCEPTION *SUB SILENTIO* WHEN IT ENACTED THE BANKRUPTCY CODE IN 1978

The panel majority's decision rested on its belief that this Court "established" the new value exception in 1939, and that, when Congress enacted the Bankruptcy Code nearly 40 years later, it "must have" done so with a "full understanding" of this doctrine, which the majority thought "has long been ensconced in our bankruptcy practice." Pet. App. 14a, 20a. Those assumptions are patently incorrect. Furthermore, in light of the vast differences between the Code and the law of bankruptcy in 1939, there is no basis for postulating that Congress implicitly meant to include a new value exception for reorganization proceedings under the Code.

"receive *nothing* under the plan." *Id.* at 416 (emphasis added).

A. A New Value Exception Was Not An Established Part Of Bankruptcy Practice In 1978

1. This Court has never "established" a new value exception. Pet. App. 14a. On the contrary, the new value exception is rooted only in dicta found in Justice Douglas's opinion for the Court in *Case*, 308 U.S. at 121-122.[20] See also *Ahlers*, 485 U.S. at 203. But the Court has never adopted those dicta to uphold the confirmation of any plan based on a new value exception; as Judge Easterbrook has noted, "[s]o far as the Supreme Court is concerned," the development of the new value exception "has been 100% dicta." *Kham & Nate's Shoes*, 908 F.2d at 1360.[21]

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[20] For historical perspective on *Case*, and in particular for Justice Douglas's view that the Court's ruling *in favor of the creditors* in that case struck a blow against the "reorganization racket[ ]," see Philip E. Urofsky (ed.), *The Diary of Wm. O. Douglas*, 1995 Y.B. SUP. CT. HIST. SOC'Y 80, 84-85. Justice Douglas's diary indicates that he was responsible for persuading his Brethren to grant the creditors' certiorari petition as well as writing the opinion of the Court.

[21] The Court repeated the *Case* dicta in *Mason* v. *Paradise Irrigation Dist.*, 326 U.S. 536, 541-542 (1946), cited by the panel majority (Pet. App. 20a n.9), but *Mason* involved purported discrimination among creditors in the *same* class, not whether a plan that permits junior interests to retain interests regardless of the treatment of more senior claims is fair and equitable. Thus, *Mason* simply does not address whether a prior equity holder may retain an ownership interest in the debtor due to a contribution of new capital, when senior creditors are not paid in full. In fact, the new funding in *Mason* was provided to the debtor in the form of a loan by a *creditor*, the Reconstruction Finance Corporation, not an equity holder. And under the plan of reorganization, the RFC did not acquire an equity interest in the debtor, a local governmental unit in California.

The panel majority also cited (Pet. App. 20a n.9) *Marine Harbor Properties* v. *Manufacturer's Trust Co.*, 317 U.S. 78 (1942), but that case is inapposite as well. *Marine Harbor* involved the dismissal of a Chapter X petition and *not* the attempted confirmation of a plan over the objection of a dissenting class of unsecured claims based on the new value exception; even in that context, the Court quoted the *Case* dicta, but noted that there was "no suggestion in the record that the equity owners desire[d] to make a contribution on that basis." *Id.* at 85-86.

Moreover, it is generally understood that the *Case* dicta themselves rely on "a misunderstanding of earlier law." BAIRD, *supra*, at 263; see also, *e.g.*, John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 999-1007 (1989); DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, BANKRUPTCY 841-843 (1993). The *Case* dicta, 308 U.S. at 121-122, are based on *Kansas City Terminal Ry. Co.* v. *Central Union Trust Co.*, 271 U.S. 445 (1926), but the two cases were decided in much different contexts. *Kansas City Terminal* was a case in which the senior creditor was owed more than the value of the debtor's assets and had *consented* to keeping the old stockholders in place, while freezing out intermediate creditors. *Case*, in contrast, involved a situation in which senior creditors were *objecting* to providing the prior equity holders with a continued interest in the business. Furthermore, *Case* "did not remark on the difference between consent and objection from the creditors," even though its dicta constituted "a dramatic step" from *Kansas City Terminal*. *Kham & Nate's Shoes*, 908 F.2d at 1361; see also Pet. App. 41a (Kanne, J., dissenting). For these reasons, "*Kansas City* offers *no* support for the proposition that the shareholders have a right to stay on board independent of the wishes of any creditor." BAIRD, *supra*, at 262.

2. It is also not true that a new value exception had "long been ensconced" in bankruptcy practice in the lower courts before 1978. Pet. App. 20a. In fact, as the Second Circuit and Judge Kanne have noted (*Coltex*, 138 F.3d at 44; Pet. App. 42a n.5), under Chapter X of the prior statute "*no* reported case seems to have adopted Justice Douglas' dicta as its holding" before 1978. Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 92 (1991) (emphasis added). As one commentator summarized,

> There appears to be no reported case in the entire period in which the court expressly permitted the "debtor," or former equity owners, to retain assets on the strength of a new value contribution and for no other reason. * * * Justice Douglas' supposed "exception" * * * is nowhere present as a rule of decision in Chapter X cases. New value under Chapter X, then, is an illusion.

Ayer, *supra*, 87 MICH. L. REV. at 1016. In addition, Chapter X — the only pre-Code business reorganization Chapter that required adherence to the absolute priority rule — had fallen into disuse; the 1977 House Report stated that "[l]ess than ten percent of all business reorganization cases are under chapter X." H.R. Rep. No. 95-595, at 222. In short, at the time Congress enacted the Bankruptcy Code, the *Case* dicta were "seemingly moribund." 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c], at 1129-108 (L. King. 15th ed. rev. 1997).[22]

3. Given the absence of any reported decision before 1978 purporting to apply the exception, the panel majority's statement that "the new value exception traditionally has played" a "major role * * * in the bankruptcy field," Pet. App. 20a, is dubious at best. And this Court has held that when a purported pre-Code "practice" is of "doubtful provenance," it is "certainly not the type of 'rule' that we assume Congress was aware of when enacting the Code." *Ron Pair*, 489 U.S. at 246; see also *United Sav. Ass'n* v. *Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380-381 (1988) (rejecting the argument that Congress intended to preserve pre-Code law, which supposedly gave undersecured creditors an entitlement to foreclose, because "it is far from clear that there was a distinctive Chapter XI rule of absolute entitlement to foreclosure").

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[22] Since *Ahlers*, very few new value plans have actually been confirmed, but the vast majority of those that have been confirmed — including the plan in the present case — have been confirmed very recently. See J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595, 619 & n.77, 644 & n.174 (1997) (available on Westlaw). Thus, ironically, the Bankruptcy Code, whose language and structure are far more inhospitable to any new value exception than pre-Code law, is being construed to allow the holders of old equity in insolvent enterprises *greater* practical opportunities to buy into a reorganized business over creditors' objections than the prior law.

Ron Pair, for example, involved pre-Code cases that had denied post-petition interest to the holders of nonconsensual liens; the "rule" at issue had been "recognized by only a few courts," and there was "some uncertainty" among them "whether this Court had ever done so." 489 U.S. at 246. The Court held that the "rule" supposedly found in those cases was not such a "well-established judicially created rule" that the Court could presume that Congress was aware of it, and implicitly approved it, when adopting the Code. *Id.* at 246-247. Similarly, in *Timbers*, the Court noted that the posited pre-Code "rule" was supported only by "dicta in some Chapter XI cases" and said that "[t]he at best divided authority under Chapter XI removes all cause for wonder that the alleged departure from it should not have been commented upon in the legislative history." 484 U.S. at 381-382.

The new value exception has an even more "doubtful provenance," *Ron Pair*, 489 U.S. at 246, under pre-Code law. The exception is based on dicta that, when the Code was enacted, were nearly 40 years old, had never been the basis for a decision of this Court upholding confirmation of a plan, and had not been relied on for the holding in any reported lower court decisions. It is hardly surprising that the legislative history does not explain why Congress enacted the absolute priority rule without a new value exception.

Because the new value exception was far from being well recognized in 1978, there is no basis for concluding that "Congress must have enacted the Code with a full understanding" of the exception, *Dewsnup*, 502 U.S. at 419, or for interpreting "silence" in the legislative history as implicit acceptance of the exception. On the contrary, "[t]here is no reason to suspect that Congress did not mean what the language of the statute says," *Ron Pair*, 489 U.S. at 246 — and the language of the statute provides in no uncertain terms for an absolute priority rule that is not subject to any exceptions.

B. The Bankruptcy Code Varies Considerably From The Bankruptcy Scheme That Spawned The *Case* Dicta

There is another reason, to which we have already alluded several times, why Congress's failure to mention the new value exception when enacting the Bankruptcy Code cannot be taken as tacit acquiescence in the exception. The bankruptcy scheme that existed in 1939 — and that prompted the *Case* dicta — was significantly different from the Bankruptcy Code adopted in 1978.

When Congress enacted the Bankruptcy Code in 1978, it fundamentally changed the law of reorganization in ways that removed any need or basis for the new value exception proposed in *Case*. As noted earlier, Congress replaced three disparate statutory schemes with a single one, Chapter 11, that "differ[s] markedly from the prior law." *Greystone*, 995 F.2d at 1282, 1285 (Jones, J., dissenting). Chapter 11 "'reflects a melding of concepts derived from several * * * distinct bodies of pre-Code law'"; Congress's "'conscious purpose'" was to "'create a new chapter that represented the best of all of these approaches to reorganization.'" Pet. App. 43a (Kanne, J., dissenting) (quoting *In re A.V.B.I., Inc.*, 143 B.R. 738, 746-747 (C.D. Cal. 1992)); see also H.R. Rep. No. 95-595, at 223-224 ("Chapter X has become an unworkable procedure, and chapter XI is inadequate to fill the void"; the new chapter 11 "adopts much of the flexibility of chapter XI of current law, and incorporates the essence of the public protection features of current chapter X").

Most significantly for purposes of this case, the statute provides for consent to a plan by votes of specified majorities of all classes, 11 U.S.C. § 1126(c), and the "fair and equitable" test applies only if class acceptance does not occur, 11 U.S.C. § 1129(b)(1). These changes mean that, if *Case* arose today, a new value exception would not be needed to ensure continued shareholder control; the vote in that case — approval by more than 90% of each class of creditors, 308 U.S. at 111-112 — would satisfy Section 1126(c) of the current Code. BAIRD, *supra*, at 262. Moreover, the Code in-

cludes an elaborate definition of the "fair and equitable" standard, 11 U.S.C. § 1129(b)(2)(A)-(C), and nothing in that definition mirrors the new value dicta articulated in *Case*. Chapter X, in contrast, had *no* definition of "fair and equitable."

These features of Chapter 11 "represent[ ] a significant change from pre-Code bankruptcy law and arguably render[ ] the new value exception unnecessary." Pet. App. 43a (Kanne, J., dissenting); see also *Greystone*, 995 F.2d at 1282, 1285 (Jones, J., dissenting). The new value exception proposed in the *Case* dicta "gave plan proponents some leverage when dealing with an obstinate *minority* of creditors who would otherwise block confirmation," but "there is no longer any need for such an exception under the [Code], given the revised confirmation standard of section 1129." EPSTEIN, ET AL., *supra*, at 844-845; see also *Kham & Nate's Shoes*, 908 F.2d at 1361. Under the Code, the absolute priority rule applies "only to the claims of dissenting *classes* of creditors impaired by the plan, and not to the claims of individual dissenters within an accepting class." Gangemi & Bordanaro, *supra*, 1 AM. BANKR. INST. L. REV. at 186-187 (emphasis added). But if each class of impaired creditors votes to accept the plan, the Code permits pre-bankruptcy equity holders to retain an interest in the debtor "even when an impaired class of creditors is not being fully compensated under the plan, and even when certain of such creditors have not actually accepted the plan" — a result "not possible under the Bankruptcy Act." Brian A. Basil, *The New Value Exception to Absolute Priority in Bankruptcy*, 101 COM. L.J. 290, 301 (1996); see also Miller, *supra*, 77 B.U. L. REV. at 1011 ("The new value exception never constituted an exception to the will of the creditors, but rather an exception to an unwaivable rule of law, the absolute priority rule."); *id.* at 1024 ("[T]he exception can only be employed when one or more classes of creditors or shareholders do not want shareholder participation. Such an exception has never existed. To write it into the law is to create new law.").

The environment in which plans of reorganization are implemented is also considerably different today. In 1939, independent trustees controlled management of the debtor during reorganization proceedings; any plan that permitted prior equity holders to remain in place required trustee approval; and, before approving any such plan, the trustee "presumably would have examined the books and operations and would have unearthed any dishonesty or mismanagement" by the previous owners. *A.V.B.I.*, 143 B.R. at 743; see also Pet. App. 44a (Kanne, J., dissenting); *Coltex*, 138 F.3d at 44. In contrast, most businesses filing for reorganization under the current Chapter 11 are operated by debtors-in-possession, and "the former protections against self-dealing afforded by trustee * * * control are no longer present." *Coltex*, 138 F.3d at 44. A new value plan today thus presents a very real danger — "'uninterrupted control by insiders,'" exercised "'for the private benefit of existing salaried management and the equity holders, with the intent of unfairly squeezing out the creditors'" — that simply did not exist in 1939. Pet. App. 44a (Kanne, J., dissenting) (quoting *A.V.B.I.*, 143 B.R. at 743); see also Miller, *supra*, 77 B.U. L. REV. at 1005-1006.

Finally, as part of its new approach to reorganization, Chapter 11 struck "a considered balance between creditor and debtor interests, which creditors, debtors, and courts must scrupulously respect." *Coltex*, 138 F.3d at 44. Congress drew from diverse bodies of pre-Code law in creating Chapter 11, and "[n]one of these predecessors contained the same balance of creditors' voting rights, pre-filing management's operational controls, and disclosure and confirmation standards." *A.V.B.I.*, 143 B.R. at 746. The Code's "comprehensive overhaul" of the law of reorganization thus "recalibrated the allocation of powers between debtors and creditors in a multitude of provisions." *Id.* at 743. The "fair and equitable" standard defined in Section 1129(b) is one part of this larger effort, and engrafting a judge-made new value exception on that statutory definition would "upset the balance sought to be achieved by Congress." *Coltex*, 138 F.3d at 44.

Given the fundamental alteration of the law of reorganization, the court of appeals improperly failed to heed this Court's admonition that, when the Code "substantial[ly]

change[s]" pre-Code practice, prior law should not be deemed incorporated into the Code. *Wolas*, 502 U.S. at 160 (refusing to import prior law into the Code because the pre-Code rule developed when the statute "was significantly narrower than it is today"). The Court so held in *Wolas* even though pre-Code cases had actually adopted a "rule" on the question at issue there, *id.* at 158; here, of course, the new value exception rests on a far more "tenuous" footing. Pet. App. 46a (Kanne, J., dissenting).

In light of the dramatic changes made in 1978 to the statutory framework for reorganizations, there is no basis for concluding that Congress meant to continue the use of an exception founded on dicta written in a significantly different legal environment. This is particularly true given that those dicta had never been followed in the ensuing four decades, the legislative history does not contain a single reference to a new value exception, and the Code as enacted effectively addresses the problem that spawned the *Case* dicta in the first place (the ability of a minority of unconsenting creditors in a class to block a new-value plan by insistence on absolute priority). Congress "carefully reexamined and entirely rewrote" the absolute priority rule in 1978; this "supports the conclusion that the text * * * as enacted reflects the deliberate choice of Congress," *Wolas*, 502 U.S. at 160 — and the text of Section 1129(b) simply does not contain a new value exception.

As Judge Kanne concluded, "cutting and pasting pre-Code practice into a fundamentally different bankruptcy context" results in a "new" statute "that Congress likely never intended." Pet. App. 46a. Faithfulness to the intent of Congress requires that the Court read the Code as written, not by reference to wholly unrealistic presumptions that Congress intended to continue an illusory pre-Code practice under the radically different provisions of the Code.[23]

[23] Some commentators perceive that two different strands of interpretation of the Code dominate this Court's precedents: careful parsing of the statutory text, as in *Ron Pair;* and interpretation of the Code by reference to pre-Code law and attention to the question whether Congress made clear its intent to change the law, as in *Dewsnup*. See BAIRD, *supra*, at 261 n.21. The latter approach is controversial among the Members of this Court. See, *e.g.*, *Dewsnup*, 502 U.S. at 432-436 (Scalia, J., dissenting). Because the very purpose of the Code was to rewrite and replace all prior law on the subject, it is hazardous to overemphasize pre-Code practice in interpreting the Code. No matter how much clarity one demands in the Code and its legislative history before finding a departure from pre-Code practice, however, the result reached by the Seventh Circuit is indefensible. The court below labored mightily to find ambiguity in a statute that is not in fact particularly difficult to read, and then it relied on a serious misunderstanding of the context within which pre-Code precedent was decided to import principles from inapposite pre-Code authority into the Code. The clarity of the law suffers from an interpretive approach that invites such a broad-ranging inquiry, and produces such erroneous results.

IV. A NEW VALUE EXCEPTION WOULD BE INCONSISTENT WITH FUNDAMENTAL BANKRUPTCY CODE POLICIES

Besides having no basis in the statutory text or the legislative history, a new value exception is inconsistent with the basic principles that undergird the Bankruptcy Code. And given the statutory framework that Congress adopted, it had good reasons not to enact a statute that included a new value exception to the absolute priority rule.

1. To begin with, a new value exception would turn the bankruptcy priority scheme on its head. The exception does more than permit prior equity holders to participate in the reorganized entity. It gives the parties in interest with the *lowest* legal priority the ultimate right to control a debtor and its property, even when their pre-petition economic position in the debtor has become valueless and senior, unsecured creditors, who will not receive payment in full of their claims, object to permitting prior equity holders to retain their stake in the business. This is contrary to a fundamental precept of the Bankruptcy Code: "the interests of shareholders become subordinated to the interests of creditors." *CFTC* v. *Weintraub*, 471 U.S. 343, 355 (1985). "Creditors effectively own bankrupt firms," *Kham & Nate's Shoes*, 908 F.2d at 1360, and whether creditors would be "better off" under a

proposed plan of reorganization is a "determination * * * for the creditors to make." *Ahlers*, 485 U.S. at 207.

This case provides a striking illustration of the vices inherent in using a new value plan to permit continued control of a debtor by the pre-petition equity holders rather than creditors, as Chapter 11 contemplates. The new value plan here prevents the bank from foreclosing and therefore from discovering for itself whether, as the bank in fact believes to be the case, the Property has a value greater than the $55.8 million found by the bankruptcy court — whether in fact it could receive a recovery on its $38.5 million unsecured claim today greater than the zero recovery on that claim that the bankruptcy judge found the bank would have received had it been instead permitted to foreclose.[24]

Instead, the plan deprives the bank of this right, providing the bank with only 16% of the present value of its $38.5 million unsecured claim. Pet. App. 28a, 133a. It does so in order (a) to perpetuate the existence of a debtor that, as the debtor has acknowledged, is "worthless in a balance sheet sense," Br. in Opp. 19, and (b) to permit the debtor's pre-petition equity holders — who will *never* have an economic stake in the Property itself — to protect themselves from the adverse personal income tax consequences they would have experienced had the bank been permitted to foreclose.[25]

[24] The bankruptcy court valued the Property at $55.8 million. Any amount actually received upon the foreclosure of the bank's "secured" claim in excess of that amount would, of course, constitute a dividend on account of the bank's $38.5 million unsecured claim. In that event, the bank would be immediately entitled to such a dividend — it would not have to wait the ten years of the debtor's plan and it would not have to endure the risks inherent in the debtor's plan, including the $5 million cash flow shortfall in years seven and eight of the plan. But most important, the bank, as the only non-insider creditor under the plan not receiving payment in full in cash on the effective date of the plan, would have (instead of being deprived of) an opportunity to have the Property subjected to the market — to learn what the true value of the Property (and thus of its "unsecured" claim) is.

[25] See *Coltex*, 138 F.3d at 46 (approving a new value plan "for the benefit of insiders" would stymie a creditor "in its legitimate attempts to obtain the value of its claims"); *Greystone*, 995 F.2d at 1282, 1285 (Jones, J., dissenting) (a new value exception "permits [an] egregious alteration of rights without the secured creditor's consent"); Lawrence B. Gutcho, *Real Estate Lenders and the Battle Over "New Value,"* 110 BANKING L.J. 423, 424-425 (1993).

Chapter 11 was intended to "enabl[e] business operations that have *positive* value to carry on." *In re UNR Indus., Inc.*, 20 F.3d 766, 771 (7th Cir. 1994) (emphasis added). It was not designed to permit "valueless" (Br. in Opp. 19) business enterprises to continue in operation, for the benefit of inside investors, while the claims of senior creditors are unpaid.

To paraphrase Professor Miller's description of another recent case: "Running through the" Seventh Circuit's "opinion is the sense not that this is an asset belonging to creditors who will lose [84%] of their unsecured claims, but rather that somehow the old owners have an interest and should have a right to redeem it. This approach runs against the Code itself, its legislative history, and the history that preceded it." 77 B.U. L. REV. at 1021.

2. When the debtor's pre-bankruptcy equity holders are given the *exclusive* right to acquire interests in the reorganized entity in return for a contribution of new value, the new value exception permits the debtor's insiders effectively to sell the debtor's property to themselves on their own chosen terms. The only check on abuse of that power is a bankruptcy judge's necessarily imperfect attempt at valuation — instead of the market discipline that would be provided if there were competitive bids from creditors or outsiders. See *Coltex*, 138 F.3d at 44 (noting the danger of "self-dealing"). No provision in Chapter 11 of the Code permits this type of self-interested conduct by the debtor's owners. See *A.V.B.I.*, 143 B.R. at 747. Indeed, case law under 11 U.S.C. § 363, the principal Code provision governing the sale of assets, flatly prohibits such closed, insider-only sales. *E.g.*, *In re W.A. Mallory Co.*, 214 B.R. 834, 838 (Bankr. E.D. Va. 1997).

Neither pre-Code law nor the Code was ever intended to allow such self-dealing. At the time of *Case*, "a disinterested, independent trustee, rather than the very interested inside debtor, would formulate the reorganization plan." Miller, *supra*, 77 B.U. L. REV. at 998. The Securities and Exchange Commission also oversaw most corporate reorganizations. *Ibid.* "SEC oversight and plan formulation by an independent trustee would assure shareholders' participation at creditors' detriment only in cases of true necessity." *Id.* at 1000-1001. But "[d]isclosure is the heart of the new Code, replacing the SEC and the independent trustee as a bulwark against fraud." *Id.* at 1005. These changes "counsel against the survival of a new value exception." *Id.* at 1018.

3. The new value exception also improperly injects the judiciary into what should be the creditors' business decisions. "[T]he Code provides that it is up to the creditors — and not the courts — to accept or reject a reorganization plan which * * * fails to honor the absolute priority rule." *Ahlers*, 485 U.S. at 207; see also *Greystone*, 995 F.2d at 1283, 1285 (Jones, J., dissenting) (Chapter 11 embodies the principle of "creditor control"). This is the creditors' "prerogative under the Code, and courts applying the Code must effectuate their decision." *Ahlers*, 485 U.S. at 207.

The new value exception reverses the roles of creditors and courts. It "means a power in the judge to 'sell' stock to the managers even when the creditors believe that this transaction will not augment the value of the firm," *Kham & Nate's Shoes*, 908 F.2d at 1360, or otherwise be in their best interests. And because of the deferential standard of review — the multi-factor test often proposed to evaluate new value plans[26] is "exceedingly vague" and "essentially factual" — "each bankruptcy court can impose its freewheeling view of reorganization policy without fear of appellate reversal." *Greystone*, 995 F.2d at 1283-84, 1285 (Jones, J., dissenting).

[26] Courts that have adopted a new value exception disagree on some of the factors that should be considered to determine whether the exception is satisfied. See *Coltex*, 138 F.3d at 45 n.5.

The Code does not give bankruptcy judges this power, and for good reason: "It is dubious to suppose that courts will ordinarily possess superior foresight than the creditors themselves concerning the creditors' best interests." *Ibid.*

4. Any judge will have difficulty in placing a value on a business enterprise. "A firm is very hard to value" even in the best of circumstances, and, because the existing shareholders necessarily have "superior knowledge about the firm," "a bankruptcy judge is not going to be as well informed as the shareholders about what its true value is." BAIRD, *supra*, at 262. This means that equity holders can wait to see whether the judge undervalues the firm, and only then commit themselves to invest in it. Thus, shareholders typically will propose new value plans when they

> are gaining at the creditors' expense. * * * In operation, the new value exception is going to systematically favor the shareholders at the creditors' expense. The shareholders do not have to plunk down any money until after they see how the judge has valued the firm. They get to place their bets after they see the other person's cards.

Id. at 263; see also Strub, *supra*, 111 BANKING L.J. at 245 (valuation is turned into a "game" in which "uncertainty [is] inherent" when, as with the new value exception, there is no "market determination of value"); Miller, *supra*, 77 B.U. L. REV. at 997-998 & nn.156-158, 1018-1019.

5. Establishment of a new value exception would also undermine bankruptcy policy in the context of consensual plan negotiations. "Negotiations are the lifeblood of a corporate reorganization," BAIRD, *supra*, at 266, and whether there is a new value exception "has significant implications for the relative bargaining power of debtors and creditors in Chapter 11 cases," *Bonner Mall*, 2 F.3d at 901. As Judge Jones has cautioned (*Greystone*, 995 F.2d at 1283, 1285 (dissent)):

> [P]ermitting the courts, pursuant to a "new value exception," rather than the creditors, under a strict absolute priority rule, to determine the conditions of former equity owners' participation in a reorganized debtor introduces

an enormously complicating factor in a carefully balanced bargaining structure.

This is because the absolute priority rule, when "applied rigorously," acts as a "powerful brake on the debtor's behavior and a strong influence on the negotiation that is likely to occur over a reorganization plan" — it "make[s] the debtor more willing to negotiate" with creditors. EPSTEIN, ET AL., *supra*, at 839. But if the absolute priority rule is watered down with a new value exception, there is a risk, as just noted, that the debtor's appraiser will convince "a sympathetic judge * * * that the value of the property in the bankruptcy estate is much lower than the creditors believe it to be." *Ibid.* This will decrease the amount paid to creditors, while at the same time permitting the debtor's pre-bankruptcy equity holders to retain an ownership interest in the post-bankruptcy business at a bargain price. *Ibid.*; BAIRD, *supra*, at 262-263; Miller, *supra*, 77 B.U. L. REV. at 1020. If, on the other hand, the absolute priority rule is "applied rigorously," each class of creditors can protect itself against the possibility of a "small recovery" (or an otherwise unacceptable reorganization scheme) by "vetoing the plan." EPSTEIN, ET AL., *supra*, at 839.

The "threat" of a new value plan thus "is often a powerful consideration at the negotiating table," Trost, et al., *supra*, SB37 ALI-ABA at 620; "[n]egotiations between creditors and the debtor against such a 'new value exception' backdrop [are] enormously skewed in favor of old equity and would seriously erode the utility of the creditors' votes." *Greystone*, 995 F.2d at 1284, 1285 (Jones, J., dissenting). As a result, the negotiations that occur in all Chapter 11 proceedings will be shaped largely by whether the absolute priority rule is limited by a new value exception. In the end, the identity of the constituency that will determine the ultimate outcome of Chapter 11 cases when the debtor is insolvent — senior, unsecured creditors or the debtor's pre-bankruptcy equity holders — will depend on the answer to the question presented in this case. And it is clear from both the Code itself and its underlying policies that senior, unsecured creditors,

rather than the holders of the insolvent debtor's equity interests, are to be that constituency.

In enacting the Bankruptcy Code, Congress intended to promote consensual plans and, at the same time, maintain the integrity of the absolute priority rule. It did so by granting the debtor the exclusive initial right to propose a plan of reorganization, see 11 U.S.C. § 1121, but providing that a plan ultimately could not be confirmed over its rejection by a dissenting class of creditors without satisfying the absolute priority rule. Thus, Congress placed the initial bargaining leverage in the hands of the debtor through its exclusive right to first propose a plan, but intended the *ultimate* leverage to be with the creditors pursuant to the absolute priority rule. See generally *Coltex*, 138 F.3d at 44 (discussing "the balance sought to be achieved by Congress" in Chapter 11). A new value exception eviscerates this congressional design by vesting both the initial *and* the ultimate leverage in the debtor's pre-bankruptcy equity holders.

6. The panel majority speculated, without citation, that the new value exception "has been a major source of new funding in reorganizations for the past fifty years" and that the absence of a new value exception might threaten "the continued existence[ ] of many corporate entities." Pet. App. 21a-22a. Aside from the factual dubiousness of that statement, discussed earlier, it simply ignores the ability of creditors to consent to a new-value plan.

Rational creditors will *consent* to a plan that involves an infusion of new value when, in their estimation, it truly is in the best interests of creditors and the estate. See *Bryson*, 961 F.2d at 504; *Kham & Nate's Shoes*, 908 F.2d at 1360. In this as in any other negotiation, if it is really true that there is a plan that is better for all concerned than is the default judicial rule — absolute priority — then back-and-forth between the parties is far more likely to produce such a result than is judicial fiat. The true policy issue in new value cases is not whether it is advisable to permit old equity holders to participate by contributing new value, but whether *a bankruptcy judge* should be able to *force* dissenting creditors of an

insolvent debtor to participate in such a plan by telling them that they have misperceived their own best interests.[27]

In any event, even if pre-bankruptcy equity holders were a significant source of reorganization funding in 1939, when the country was not yet out of the Depression, today's capital markets make it much easier for worthwhile ventures to obtain financing. See Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 672 (1974) ("Current data do not support the belief that old shareholders are a fruitful source of additional funds when the public capital markets are unlikely to provide funds. In recent years shareholders have seldom contributed new capital."). More particularly, empirical evidence supports the proposition that creditors often consent to plans that would violate the absolute priority rule. See, *e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990). A reorganized company's inability to induce creditor consent *or*

[27] Courts that endorse a new value exception have offered the ability to engage in such judicial second-guessing as a positive virtue of the exception. See *In re Snyder*, 967 F.2d 1126, 1129-1130 (7th Cir. 1992) (business judgment of creditors in rejecting plan may not warrant exclusion of old equity). This is contrary to fundamental bankruptcy policy. See *Ahlers*, 485 U.S. at 207 ("the Code provides that it is up to the creditors — and not the courts — to accept or reject a reorganization plan"). It is also contrary to the specific statutory provisions of 11 U.S.C. § 1126(e). That statute permits the bankruptcy judge to discard a creditor's vote, "[o]n request of a party in interest, and after notice and a hearing," *only* upon finding that "such acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." A vote cast based on a *creditor's* assessment of its own economic interest is always cast in good faith. See *John Hancock Mut. Life Ins. v. Route 37 Bus. Park*, 987 F.2d 154, 161-162 (3d Cir. 1993); *In re Federal Support Co.*, 859 F.2d 17, 20 (4th Cir. 1988). (Not surprisingly, the debtor did not challenge the propriety of the bank's votes under 11 U.S.C. § 1126(e). See Pet. App. 114a-128a.) Thus, this type of judicial second-guessing under the guise of application of the new value exception runs afoul of 11 U.S.C. § 1126(e).

to convince anyone other than a pre-petition equity holder to lend it money today suggests not a failure of the capital markets as much as a realistic assessment that the reorganization is unlikely to succeed.

7. Chapter 11 "embodies the general Code policy of maximizing the value of the bankruptcy estate." *Toibb*, 501 U.S. at 163. In the long run, however, a new value exception is more likely to undermine than to further that policy. It will tend to give a new, but short, lease on life to a company that may expire thereafter with assets whose value has further eroded. Many Chapter 11 reorganizations are unsuccessful; according to one study, approximately 40% of all Chapter 11 cases are eventually converted to Chapter 7 liquidations. Basil, *supra*, 101 COM. L.J. at 304 & n.90. By the time the debtor's assets are liquidated in a Chapter 7 proceeding,

> it is probable that any funds reinvested by debtor's shareholders will have dissipated, and the hard assets from which the unsecured creditors ultimately receive payment will have depreciated. Thus, the net result of having applied the new value exception will have been to diminish, rather than maximize, the value of the estate from the perspective of unsecured creditors.

Id. at 304; see also James J. White, *Absolute Priority and New Value*, 8 COOLEY L. REV. 1, 29-31 (1991) (the purported economic benefits of a new value exception are "speculative"; "it seems more probable than not that abolition of the new value exception will enhance, not diminish, the efficiency of the most probable plans").

8. At bottom, a new value exception is contrary to the underlying premise of equity ownership in an enterprise: in exchange for its greater potential for return, equity takes the greater risk of loss. See Basil, *supra*, 101 COM. L.J. at 302-303. It is antithetical to the principles underlying the absolute priority rule to permit a debtor's equity holders, who would have kept all of the profits in the enterprise had there been any, to shift the risk of loss to a senior class of creditors when business turns sour, yet retain the exclusive right to

continue to own and control the reorganized debtor through the contribution of new value.

"New value has gone from a regrettable but necessary incursion into creditors' rights to an accepted means for the owners of debtors to cancel debt and keep ownership. No matter how history is read, this was never one of the new value exception's purposes." Miller, *supra*, 77 B.U. L. REV. at 1022. The Bankruptcy Code "was not meant to provide a way for owners of * * * partnerships[ ] to keep the ownership without paying the debts." *Ibid.* The Court should decline to read the Code in such a fashion.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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ADDENDUM

SECTION 1129 OF THE BANKRUPTCY CODE (11 U.S.C. § 1129)

§ 1129. Confirmation of plan

In this title—

(a) The court shall confirm a plan only if all of the following requirements are met:

* * *

(8) With respect to each class of claims or interests —
(A) such class has accepted the plan; or
(B) such class is not impaired under the plan.

* * *

(b) (1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides —

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the

allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims —

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a class of interests —

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

(c) Notwithstanding subsections (a) and (b) of this section and except as provided in section 1127(b) of this title, the court may confirm only one plan, unless the order

of confirmation in the case has been revoked under section 1144 of this title. If the requirements of subsections (a) and (b) of this section are met with respect to more than one plan, the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm.

(d) Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933. In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.